Reforming Central Banks

Testimony By

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In the past twenty-five years, central banking has been transformed in all developed countries. Several announce inflation targets and make serious and generally successful efforts to achieve the targets. The ECB uses judgment about current or recent data, supplemented by concern about money growth, the "second pillar" of its strategy. The Federal Reserve continues a discretionary policy.

All of the techniques have been much more successful than previous policies or methods of operation. Although they differ in their approach, current operations have two common features. First, central banks are more independent of politics and government than in the past. This is obvious in Britain or New Zealand where the meaning of central bank independence and its limits are set out explicitly in an agreement between the government and the central bank. Second, central banks now give much more weight to avoiding inflation than in the past.

In the 1960s and 1970s, the mantra preached by central banks told the public that inflation would start to rise before the economy reached full employment. Price and wage guidelines were a necessary policy tool to achieve full employment with price stability or low inflation. Instead of getting lower unemployment and lower inflation, major countries--Britain and the United States especially—had higher inflation and rising unemployment.

Even the politicians noticed the failure. More importantly, the voters noticed that countries like Germany and Switzerland put more effort into controlling inflation and did not suffer higher average unemployment.

Governments and central banks discarded the old mantra. Guideposts and wage controls went into the dustbin where they belong. In their place was a new mantra preaching a very different view.

The new claim is that sustained low inflation or price stability is a necessary condition for sustained full employment. Free markets work better than controls. The approximately twenty-five recent years of low inflation have strengthened this belief. With floating exchange rates and low inflation, Britain and the United States have had long expansions and relatively mild recessions. The United States is now in a third long expansion. Aided by more rapid productivity growth, living standards have soared.

Maintaining low inflation has worked extremely well in Britain and the United States but less well in the European countries that joined the European Central Bank. Within the ECB the experience of countries like Ireland with pro-growth policies differs markedly from countries like Germany or Italy that tax and regulate excessively. Virtually everyone recognizes that in Germany, France, and Italy the required solutions to current problems are real not monetary and more generally political, not economic.

Central banks in Britain and the United States should not rest on the achievements of past reforms, important as they are. Both now claim to value transparency and clear communication, a break from the past secrecy that central bankers once prized. It took many decades for central bankers to recognize that just as financial markets depend on them, they depend on financial markets. In principle, interdependence has become accepted.

Central bankers have not explained an ever present part of the uncertainty that accompanies all economic change. The duration of any change is often in doubt. A change may be temporary or persistent. Changes may alter the level or the growth rates. Usually it takes time to decide the type of change that has occurred.

Inflation occurs when the central bank lets money grow persistently above the growth rate of real output. The price level rises steadily and continues to rise as long as the central bank remains on this course. Contrast this inflation with a rise in the price level that continues for a few months or a year. Money growth is unchanged. The rise in the price level can be the result of an oil shock, an increase in excise taxes, devaluation of the currency, and many other one-time changes. As the change spreads through the economy, the price level rises. The rise is typically spread over time so that the rate of price increase at first looks very similar to the monetary inflation just discussed. The difference is that the one-time increase does not persist. Oil prices do not rise from $35 to $70 a barrel this year and to $140 a barrel next year. Central banks must learn to distinguish these one-time increases from the sustained inflation that they, and only they, can cause.

Some make the distinction, or appear to, when they describe their role as preventing the surge in oil prices from increasing the expected rate of inflation. Many market watchers do not make the distinction, and some official statements are misleading. Central banks should clarify their role.

Separating one-time changes from persistent changes is a major problem. Decades ago, in 1948, the late, distinguished economist Jacob Viner wrote to the President of the New York Federal Reserve to caution him about over-responding to transitory changes. Viner wrote:

> "You certainly have the advantage over me of being closer to the market, but it may not be an unmixed advantage. The ticker may loom too large in your perspective and what from the point of view of the national economy are molehills may … appear to you as mighty mountains."

Mistaking one-time price changes for inflation can be costly. An oil price increase is a tax on consumers and producers. Whether it comes as a restriction of supply as in the 1970s or mainly an increase in demand, as currently, it is a non-monetary event. Reducing money growth to role back the effect of the oil price increase is costly. The first effect is to reduce output or its growth rate. Further, letting the price level rise but holding the maintained rate of inflation unchanged is a low cost way of reducing real incomes, a reduction that must be made to pay the oil producers for the real increase in the cost of their product.

Central bankers and markets must become more familiar with the duration of changes—whether the change is permanent or temporary. They can not do that if they adjust policy fully to new information at each meeting.

Central banks must develop and hold to medium-term strategies. One reason that use of inflation targets has improved policy outcomes is that they encourage attention to the medium term. Central bank directors have to look ahead and give less attention to transitory, often random movements.

In recent years, we have had expansions that are longer than average. It is not chance or accident. It results from better decisions and better policies with more attention to the medium-term.

Central banks should announce and follow a policy rule that seeks stability over the medium-term.